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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF SECRETARY

EX PARTE

William F. Caton
Acting Secretary
Federal Communications Commission
Mail Stop 1170
1919 M Street, N.W., Room 222
Washington, D.C. 20554

Dear Mr. Caton:

Re: *CC Docket No. 80-286 - Amendment of Part 36 of The Commission's Rules and Establishment of a Joint Board, CC Docket No. 94-1 - Price Cap Performance Review for Local Exchange Carriers*

Rex Mitchell, Regulatory Vice President, Pacific Bell, and I met with Michael Katz, Chief Economist, Office of Plans and Policy. Please associate the attached material with the above-referenced proceedings.

We are submitting two copies of this notice in accordance with Section 1.1206(a)(1) of the Commission's Rules.

Please stamp and return the provided copy to confirm your receipt. Please contact me should you have any questions or require additional information concerning this matter.

Sincerely,

cc: Michael Katz

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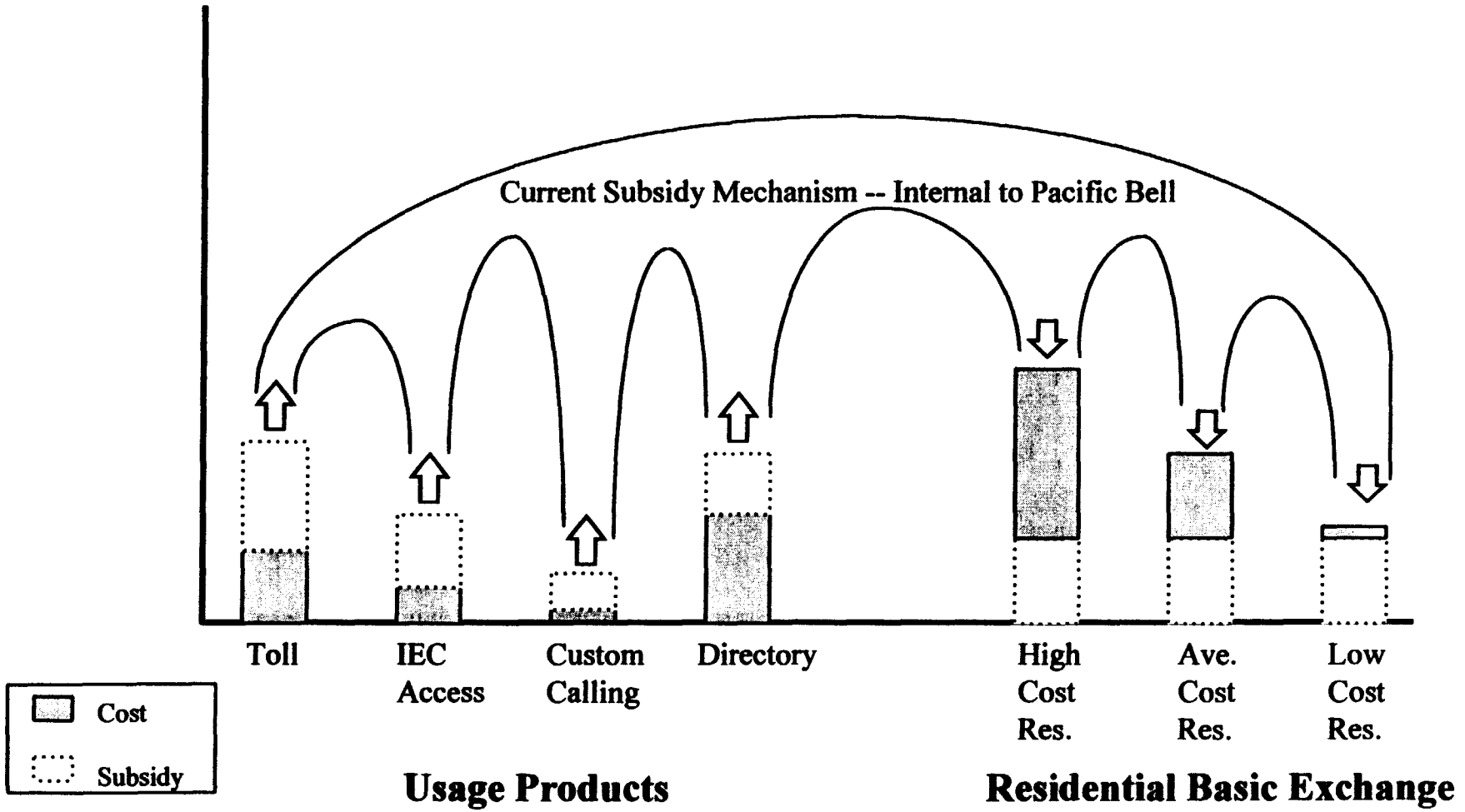
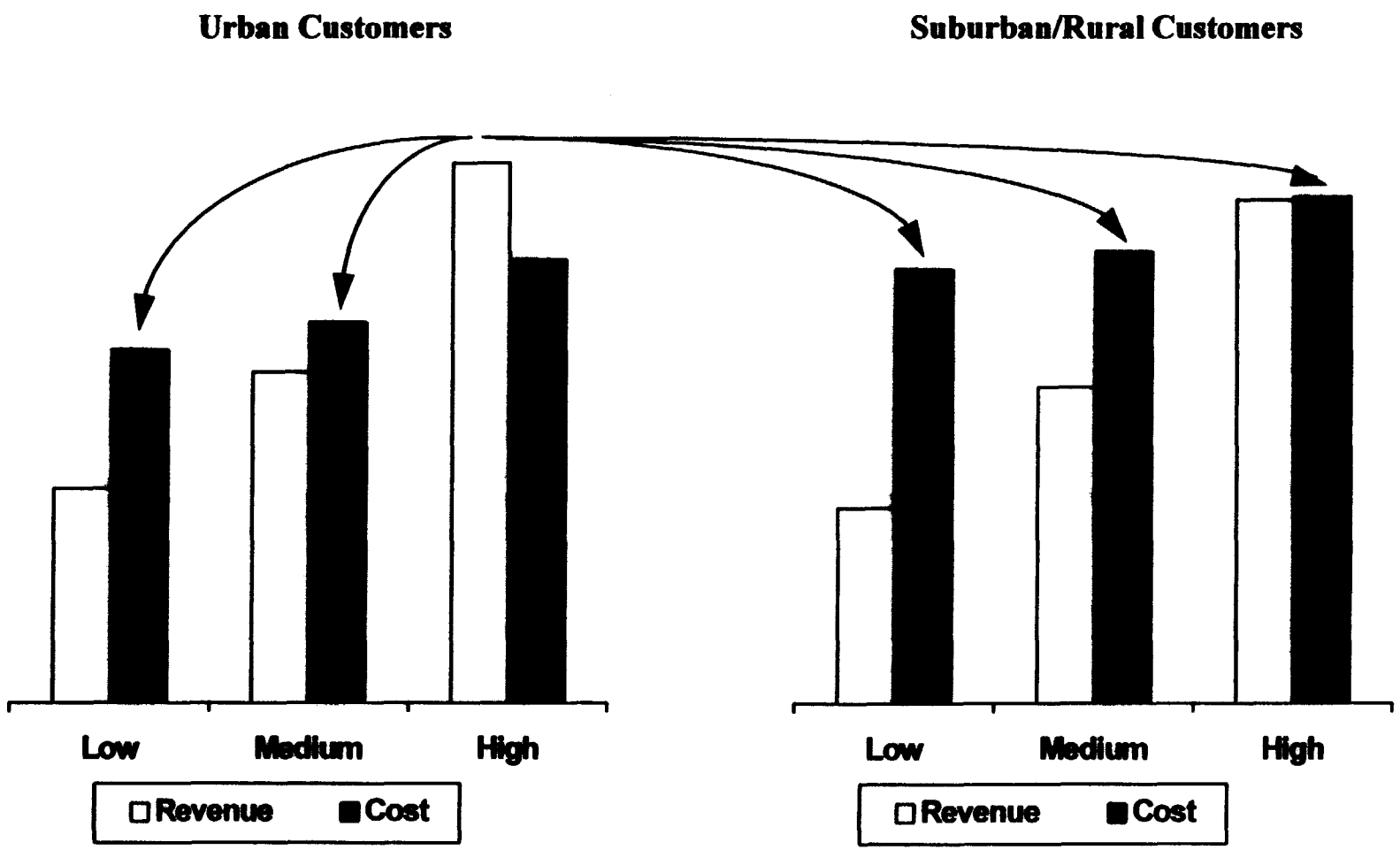
List A B C D E

Universal Service

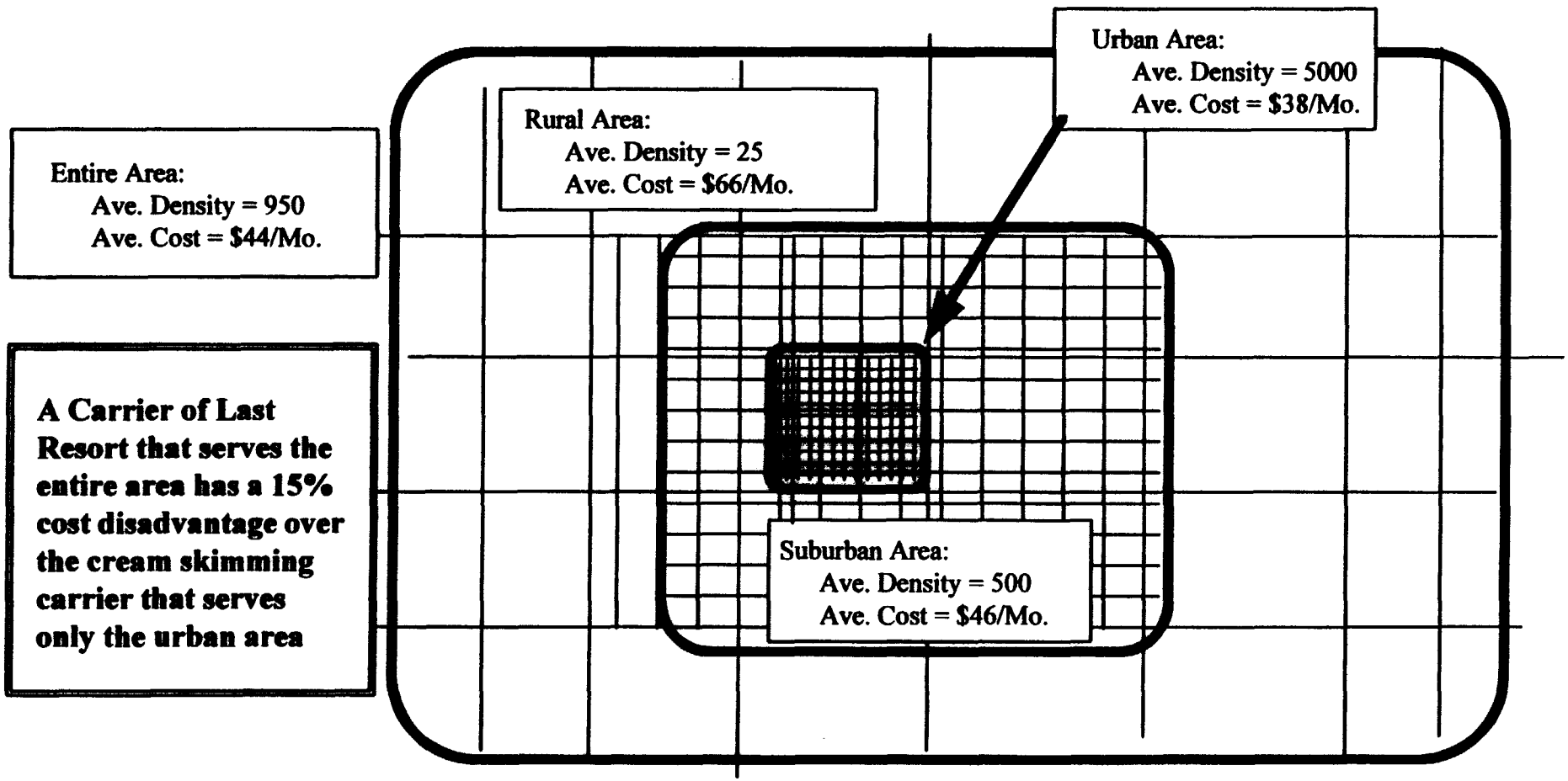
Universal Service is Maintained Today by Subsidies Internal to Pacific Bell (and Other LECs)



On a Residential Customer to Customer Basis, the Subsidy Flows From Urban to Suburban/Rural and High Use to Low Use

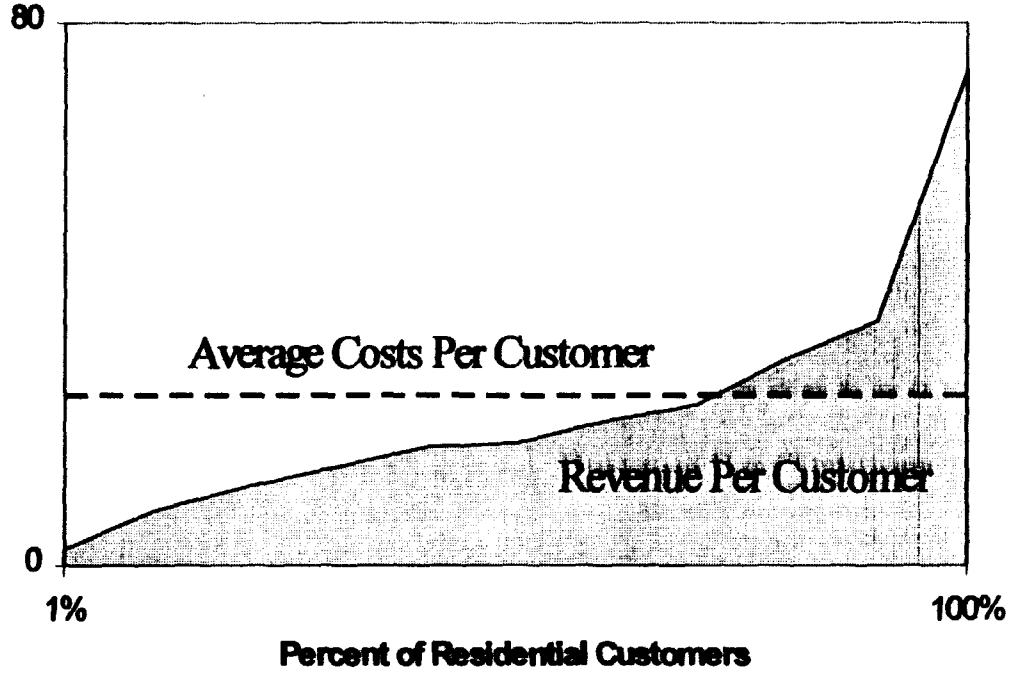


Subsidy Within the Exchange Area Can Occur Even Within a Rural Exchange

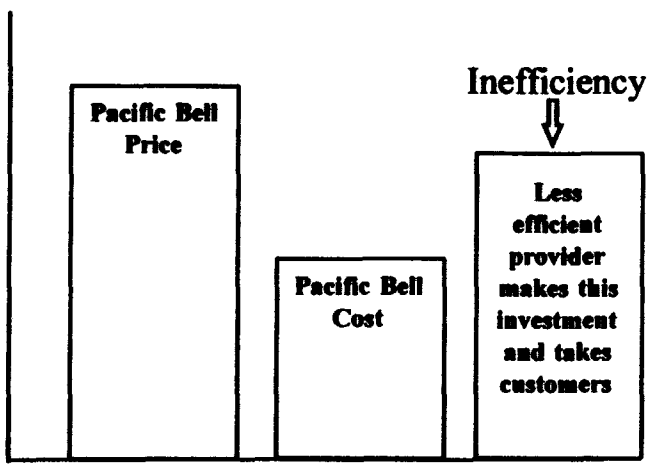


A Very Small Number of Residential Customers are Paying the Cost of a Very Large Body of Residential Customers

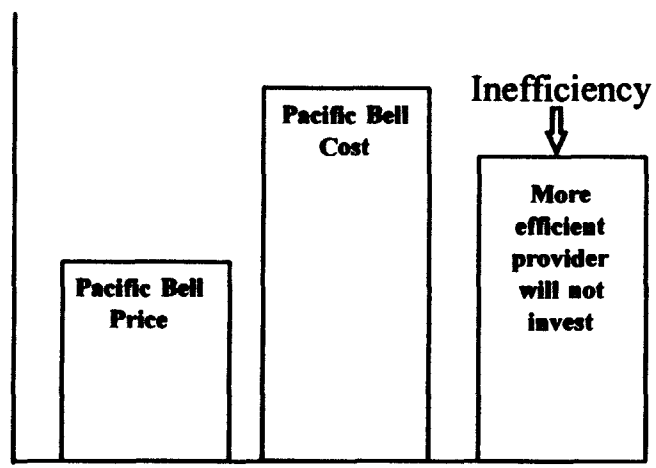
- This is a very serious cream-skimming opportunity



The Economic Result is That a Less-Efficient Provider Could be Attracted to Invest While a More-Efficient Provider Could be Discouraged From Investing



Product A or Area A



Product B or Area B

The net result is that California encourages an inefficient deployment of investment. Already we see four providers of fiber networks overbuilding each other in dense metropolitan areas and no one clamoring to serve rural areas.

If Competition is Allowed Without Addressing the Subsidy Issues, Two Important Consequences Occur:

- No competition will develop where Pacific Bell prices are held artificially ***low***.
  - There will be no competition for suburban/rural customers, low use customers and high cost customers.
- Super-competition will develop where Pacific Bell prices are held artificially ***high***.
  - There will be extraordinary competition for toll and access, especially in dense areas.

This is Perhaps More True in California Than Elsewhere in the Country

- Residential rates are low and intraLATA toll and interLATA access provide a huge subsidy.
- California has the extremes of very densely populated cities and a large rural economy.

	Basic Rate (1FR)	Toll Revenue Per Line	State Access Revenue Per Line
California	$11.25	$112.00	40.00
New York	7.10*	22.00	31.00
Illinois	5.67*	14.70	12.40
Michigan	14.38	130.70	42.00

*Mandatory measured service for all residence customers.

The Subsidy Mechanism Worked Perfectly Well in a Closed System of a Single Monopoly Provider

- Important societal goals were achieved and economic distortions were minimized.

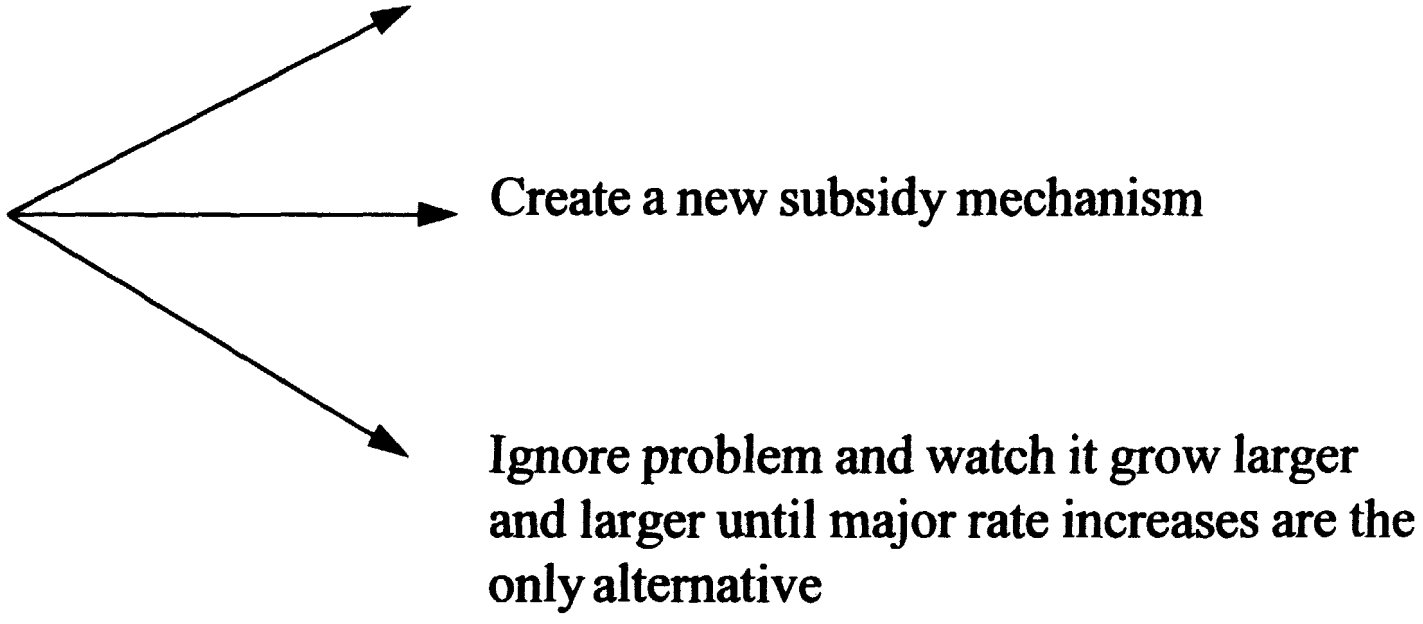
Important Social Goals

- Statewide averaged rates kept rural rates low.
- Low residential basic exchange prices maximized penetration of telephone service.

Minimal Economic Distortion

- Large users could avoid subsidizing residential basic exchange services *only* by building private networks.

In a Competitive Environment, However, Public Policy Makers Must Either Abandon These Important Social Goals or Create a Universal Service Subsidy Mechanism That Works in A Competitive Environment. Any Other Condition Ignores Economic Reality.



There is a Viable Alternative to Rate Rebalancing or Total Loss of the Subsidy

- An external mechanism, applicable to all providers, that preserves existing subsidy flows could be implemented.
  - The customers of all providers of ***subsidizing*** services would contribute to the subsidy fund.
  - The customers of all providers of ***subsidized*** services would receive the benefit of subsidy funding.

Universal Service Alternative Plan

Universal Service Fund - Collection Mechanism

- The size of the fund would initially be determined based on incumbent LEC costs.
- The total amount of the fund shall be the difference between the revenue from residential basic exchange service as defined by policymakers and the incremental cost of such service, plus a reasonable share of joint and common costs.
- A surcharge will be imposed on the end-user telecommunications revenues of all certificated telecommunications companies to establish and maintain funding that is broadly-based and competitively-neutral.

Universal Service Fund - Distribution Mechanism

- The subsidy fund shall be distributed to local exchange carriers on a per-residential service address basis, for areas where the provider is certified as a carrier of last resort.
- Incumbents LECs shall reduce the price of subsidizing services, dollar-for-dollar, to offset anticipated fund payments.

Universal Service Alternative Plan

Universal Service Fund - Sizing the Subsidy

- A cost proxy model will be used to estimate the amount of subsidy per residential service address.
- The model will incorporate primary cost drivers such as population density, loop length, geological terrain characteristics (e.g., type and depth of bedrock) and street layouts.
- The subsidy level per residential service address will be calculated as the difference between the Commission-approved price and the proxy costs.

Universal Service Fund - Eligibility

- To be eligible to receive funds, the local exchange carrier agrees to be the carrier of last resort for residential and business subscribers within their serving area, using their own loop or loop-equivalent facilities.
- The local exchange provider must offer residential basic service as defined by policymakers at a price set by the Commission.
- All eligible fund recipients shall also meet Commission-established service quality and provisioning interval requirements.

Adoption of a Universal Service Funding Mechanism Preserves Important Commission Goals in a Manner Consistent with Local Competition

- Economic benefits -- competitors would invest where they are more efficient than Pacific Bell rather than where they are protected by artificially high Pacific Bell prices.
  - ➔ *leading to efficient deployment of societal resources*
- Societal benefits -- averaged prices and subsidy to residential customers would be preserved in a competitive environment.
  - ➔ *consumers would not be encouraged to change providers in order to avoid the subsidy*

Universal Service as Addressed in Legislation

Senate (S. 652)

- Requires a joint board
- Rural and high cost areas to have service and rates reasonably comparable to urban areas
- Requires participation by all telecommunications carriers in a nondiscriminatory basis
- Prohibits geographic deaveraging of toll
- May have higher standard for schools, libraries and health care institutions
- States or the FCC may designate multiple essential carriers (for services within their respective jurisdictions).

House (H.R. 1555)

- Requires a joint board
- Adequate and sustainable support mechanism
- Requires equitable and nondiscriminatory contribution by all providers of telecommunications services
- Prohibits geographic deaveraging of toll
- May have higher standard for schools
- Telecommunications Development Fund

The FCC's NPRM on Universal Service Funding

- The NPRM provides the framework for evaluating universal service in a comprehensive way
- FCC goals for universal service will facilitate the evolution of the current mechanism into the competitive environment
  - maintain competitive neutrality of any funding mechanisms
  - provide incentives for efficient investment and operations
  - reduce barriers to competitive entry
- The use of proxy costs and smaller geographic areas will foster competitive neutrality, efficiency and the targeting of subsidy to truly high cost areas, regardless of who is providing the service